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UNCLAS E F T O SECTION 01 OF 05 BEIJING 000259

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STATE ALSO FOR OES/WATSON AND DEROSA-JOYNT
STATE PASS CEQ CONNAUGHTON
STATE PASS CEA FOR BLOCK, SLAUGHTER
STATE PASS USTR FOR STRATFORD, ALTBACH, WINTERS, CELICO
STATE PASS FEDERAL RESERVE BOARD FOR JOHNSON/SCHINDLER; SAN
FRANCISCO FRB FOR CURRAN/LUNG; NEW YORK FRM FOR DAGES
NSC FOR RHUNTER/JSCHRIER/KTONG
TREASURY FOR OASIA/INA DOHNER/HAARSAGER/BAKER/CUSHMAN
TREASURY FOR TAIYA SMITH
DOE FOR INTERNATIONAL/PUMPHREY AND GEBERT
EPA FOR INTERNATIONAL/AYRES, FIDLER, MCASKILL
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SUBJECT: STRATEGIC ECONOMIC DIALOGUE (SED) OPENING SESSION
ON CHINA'S DEVELOPMENT STRATEGY

1. (SBU) Summary: During the December 14 opening of the Strategic Economic Dialogue (SED), Vice Premier Wu Yi and National Development and Reform Chairman Ma Kai, presentations on China's development road and strategy broke little new ground and drew largely from 11th Five-Year Plan documents. Vice Premier Wu discussed 1) cultural and historical factors underpinning China's development strategy, 2) China's status as a poor country facing development challenges and 3) China's development goals. Chairman Ma followed up with a discussion of China's development strategy. The large amount of time allocated to Ma during the SED sessions, far greater than other ministers, appeared designed to signal his enhanced role in economic policy making. In their interventions, Chinese officials stressed the priority placed on more balanced development, particularly between rural, urban, western and coastal regions.

2. (SBU) USTR Schwab, emphasizing the importance of markets, argued for a limited role of government in the economy. Her remarks noting China's backtracking on reforms and incomplete transition to a market economy and rule of law sparked defensive responses from Vice Premier Wu, Chairman Ma and others. End summary.

Opening Statements

3. (SBU) At the December 14-15, 2006 first meeting of the SED, Treasury Secretary Paulson and Vice Premier Wu Yi led discussions of long-range, cross-cutting strategic economic issues affecting the United States and China. Secretary Paulson, six other Cabinet members, the Federal Reserve Chairman, and senior officials from State, Transportation, the Council of Economic Advisors and the U.S. ExIm Chairman exchanged views with the Vice Premier and twenty Ministers or

Vice Ministerial-rank officials. Vice Premier Wu Yi opened this unprecedented gathering of so many of the two sides' leading policymakers by emphasizing the following points:

- o The SED will help increase bilateral trust and cooperation and facilitate constructive relations.
- o The SED should focus on macro-level long-term and strategic issues.
- o The SED will not replace existing bilateral dialogues but can be used to address issues of immediate importance.
- o China hopes the SED will help the United States grasp a more holistic view of China's development plans and challenges.
- o The SED should be based on mutual respect, cooperation and equality.

14. (SBU) Secretary of the Treasury Henry Paulson agreed the SED should address long-term issues and pressing short-term problems. He noted the United States intended to focus on:

- o Achieving sustainable growth without large imbalances.
- o The importance of open markets, rule-of-law, property rights and transparency.
- o Energy and the environment.

Vice Premier Wu Yi: China's Development Road

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15. (SBU) Vice Premier Wu noted that the choice of "China's Development Road" as the SED theme was motivated by a perception that the United States neither fully understands China's development strategy nor appreciates the challenges it faces. China's development, she said, should be viewed as an opportunity, not a threat. Her presentation touched on themes consistent with priorities laid out in China's 11th Five-Year Plan. A summary of the Vice Premier's presentation follows:

- o Peaceful development: China's development strategy is driven by 1) a culture that values harmony and has a long history of diplomacy (e.g., the Silk Road, Zheng He's sea voyages) and 2) a painful, humiliating history of war and foreign domination that underpins China's quest for peace and stability (e.g., the Opium War, First Sino-Japan War, the War of Japanese Aggression (i.e., WWII)).
- o Economic development challenges: China remains a developing country facing high income inequality, unbalanced development, rural poverty and weak public services (particularly for rural residents). In the coming two decades 300 million rural migrants will move to urban areas.
- o Development goals: Expand China's &well-off8 society to over one billion people by 2020 and become a medium developed country by 2050.
- o Development conditions: China can sustain high economic growth for the next 15 years, has huge market demand, high household savings and abundant labor.
- o Development model: 1) Move away from a resource and capital intensive, high polluting model towards a high productivity, resource and environmentally friendly model, 2) encouragedomestic demand through rural reform and expand social services to reduce precautionary savings, 3) nurture independent innovation, 4) balance regional development, 5) strive for energy self-sufficiency by increasing conservation and 6) improve the environment by reducing energy

consumption, increasing efficiency and lowering waste and emissions.

o Economic reform: China is a market economy (over 95 percent of retail commodities are market-priced and the non-state owned sector now accounts for over 60 percent of value added) and public ownership is the &mainstay8 of the economic system. China is working to: 1) increase the role of the market in determining resource allocation, factor pricing and enterprise competitiveness, 2) improve macro-economic controls, 3) perfect its legal framework, 4) intensify IPR protection and 5) support and expand the multilateral trading system.

o Political reform: China endeavors to 1) promote rule of law, 2) make government more responsive and 3) protect human rights based on international conventions.

Secretary Paulson Responds

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¶6. (SBU) Secretary Paulson noted the major question confronting China is the pace of reform. China's size and global integration, he continued, makes it harder to manage reform with a mix of market and administrative approaches. The greatest risk, he opined, may be in not moving quickly enough. While China is a developing country, he said, its economic size and integration magnifies the impact of China's

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policies on the global economy. As China develops, he predicted, its global partners will become increasingly impatient.

¶7. (SBU) Secretary Paulson stressed that China must rely more on markets to determine prices and allocate resources and rely more on competition to build strong companies. In particular, China's service sector would benefit from greater liberalization. This, he said, would help China build dynamic capital markets. Failure to do so, he warned, will increase costs as Japan experienced in the 1990s. He agreed with Vice Premier Wu that market-based pricing can help China achieve its environmental goals.

NDRC Chairman Ma Kai: China's Economic Development Strategy

¶8. (SBU) NDRC Chairman Ma's presentation covered six core areas of China's development strategy and was essentially an outline of China's 11th Five-Year Plan:

¶I. Boost domestic demand through: 1) strengthening household consumption, 2) revitalizing the industrial sector by increasing corporate investment, and 3) accelerating urbanization.

II. Adjust China's economic structure by: 1) upgrading agriculture, 2) promoting innovation to move up the value chain, and 3) developing the services sector.

III. Conserve resources/protect the environment by: 1) reducing energy consumption and pollution, 2) increasing forest coverage, 3) promoting services and high tech, and 4) improving the legal framework and increasing budgetary resources to enforce environmental laws.

IV. Promote more balanced development by: 1) promoting urbanization, 2) improving rural infrastructure and services and increasing fiscal outlays to rural areas, and 3) promoting regional development campaigns like &Promote the West8, &Revitalize the Northeast8 and &Rise of the Central Region.8

¶V. Promote innovation and education by: 1) extending the coverage of compulsory education, 2) providing vocational

training, and 3) increasing R&D funding.

VI. Continue reform by: 1) liberalizing trade and services, 2) encouraging private sector development, 3) promoting administrative reform, 4) accelerating financial sector reform, 5) liberalizing administered prices, particularly of resource-based products, 6) improving the exchange rate mechanism and striving for basic import/export balance, 7) attracting higher quality foreign investment, and 8) encouraging Chinese enterprise investment and cooperation abroad.

China's Economic Development Strategy) United States Perspectives

¶9. (SBU) USTR Susan Schwab's presentation focused on three areas:

I) the role of government and markets: Governments create the environment for innovation but shouldn't control outcomes. Flaws emerge when governments intervene.

II) Three development models: 1) a widely rejected central planning model, 2) a transparent free market model, and 3)

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the &East Asian8 model characterized by selective government intervention, which misallocates resources, insulates market participants from market forces and contributes to corruption and trade friction.

III) China's incomplete transition: Key sectors are not guided by market signals, the rule of law is underdeveloped, market access barriers persist and reform is backsliding. An example is overcapacity in the steel industry.

¶10. (SBU) USTR Schwab noted China's incomplete transition threatens its development and bilateral relations, as well as the stability of the global economy.

¶11. (SBU) Secretary of Energy Samuel Bondman echoed User's comments on China's incomplete transition. He further noted the importance of environmental and IPR protection. The Department of Energy, he added, stands ready to explore ways to aid China's economic transition.

¶12. (SBU) Secretary of Commerce Carlos Gutierrez noted that China's progress in the past 28 years is unprecedented. The free market model discussed by USTR Schwab, he continued, is the one the United States eventually reached.

¶13. (SBU) Matthew Slaughter, Member of the Council of Economic Advisors, noted that United States economic growth is built on entrepreneurship and the success and failure of private firms. This facilitates innovation. A flexible labor market and deep capital markets are additional key factors.

Chinese Response

¶14. (SBU) Vice Premier Wu asked USTR Schwab for evidence that China was backsliding on reform. USTR Schwab cited China's promulgation of merger and acquisition rules, regulations limiting foreign distribution of economic news, postal reform that threatens foreign market access and potentially restrictive government procurement regulations. China, Schwab said, appears to be picking winners and losers, a strategy proven to be ineffective in other countries.

¶15. (SBU) NDRC Chairman Ma said it was difficult to agree with USTR Schwab's comments. He reiterated China's intent to promote the private sector. China, he stated, will allow the market to play a basic role guided by government macro-control. This approach is distinct from either a fully

planned or a laissez-faire model. The challenge, he opined, is striking the balance between the role of the market and macro-control. Ma challenged USTR Schwab's comments on China's steel industry, saying market forces determine what and how Chinese enterprises produce, where they invest and whether banks lend to them. Except for a very few items, he said, pricing is free from government influence. Ma admitted there is excess investment, but the government has taken steps to correct this by tightening monetary policy, adjusting land management policies and reducing the VAT rebate for steel exports.

¶16. (SBU) NDRC Vice-Chairman Zhang Xiaoqing questioned USTR Schwab's comments on China's postal reform. China, he said, is moving to separate the government from service provision and towards a market-based system. In the next 1-2 months, he predicted, China will establish a postal system governed by modern corporate principles. Perhaps, he suggested, the USG is unhappy with certain aspects of postal reform. Nonetheless, it should not deny that the overall direction is

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positive. Minister of Information Industries Wang Xudong added that China's reform in this sector is proceeding at an appropriate pace.

Participants List

¶17. (U) United States Delegation:

- Henry Paulson, Secretary of Treasury
- Clark T. Randt, Jr., United States Ambassador to China
- Michael Leavitt, Secretary of Health and Human Services
- Samuel Bodman, Secretary of Energy
- Carlos Gutierrez, Secretary of Commerce
- Elaine Chao, Secretary of Labor
- Susan Schwab, United States Trade Representative
- Stephen Johnson, Administrator of the Environmental Protection Agency
- Benjamin Bernanke, Chairman of the Federal Reserve
- James Lambright, Chairman and President of Ex-Im Bank
- Daniel Sullivan, Assistant Secretary, Department of State
- Andrew Steinberg, Assistant Secretary, Department of Transportation
- Matthew Slaughter, Member of the Council of Economic Advisors

¶18. (U) Chinese Delegation:

- Wu Yi, Vice Premier
- Jin Renqing, Minister of Finance
- Ma Kai, Chairman of National Development and Reform Commission
- Xu Guanhua, Minister of Science and Technology
- Tian Chengping, Minister of Labor and Social Security
- Liu Zhijun, Minister of Railways
- Li Shenglin, Minister of Communications
- Wang Xudong, Minister of Information and Industry
- Bo Xilai, Minister of Commerce
- Gao Qiang, Minister of Health
- Zhou Xiaochuan, Governor of People's Bank of China
- Li Changjiang, Administrator of General Administration of Quality Supervision, Inspection, and Quarantine
- Zhou Shengxian, Administrator of State Environmental Protection Administration
- Zhou Wenxiong, Chinese Ambassador to the United States
- Xu Shaoshi, Deputy Secretary-General, State Council
- Yang Jiechi, Senior Vice Minister, Ministry of Foreign Affairs
- Zhang Xiaoqiang, Vice Chairman, National Development and Reform Commission
- Li Yong, Vice Minister, Ministry of Finance
- Yi Xiaozhun, Vice Minister, Ministry of Commerce
- Hu Xiaolian, Vice Governor, People's Bank of China
- Li Ruogu, Chairman of China Export-Import Bank

